SUPREME COURT, U. S.

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No. 911

IN THE

Supreme Court of the United States

October Term, 1966

J. E. DAVANT, ET AL., *Petitioners*

v.

COMMISSIONER OF INTERNAL REVENUE

On Petition For A Writ Of Certiorari To The United States Court of Appeals For The Fifth Circuit

REPLY BRIEF OF PETITIONERS

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REPLY BRIEF OF PETITIONERS

We respectfully submit that a real consideration of the points sought to be made by respondent in his memorandum in opposition clearly demonstrates how erroneous are the decisions of the courts below. In this discussion we will assume that the sale of the stock to Bruce, Jr. did not occur, *but we do not thereby waive our contentions that it should be recognized.*

Let us state the facts simply:

Petitioners had owned for over 25 years all the stock of the Warehouse Company and the Water Company. Warehouse had $215,000 cash in bank. Water Company bought all the assets of the Warehouse except its cash for $700,000 cash, of which $500,000 was borrowed from a bank at the time of the purchase. The Tax Court held, and the respondent admits, that the fair value of those assets was at least $700,000. Warehouse dissolved and distributed the $915,000 to petitioners, its stockholders, *who paid their income tax thereon on a capital gains basis,* and respondent in footnote 3 on page 4 of his memorandum admits this was correct if there was no reorganization under sec. 368(a)(1)(D). The respondent in the Tax Court contended there was a reorganization under sec. 368(a)(1)(D) and (F) and petitioners should be treated as receiving a dividend equal to the combined earnings of the Warehouse and Water Company. The Tax Court held there was a reorganization under sec. 368(a)(1)(D) but not under sec. 368(a)(1)(F) and that petitioners received under sec. 356 dividends to the extent of the earnings of Warehouse but not of Water Company. Although respondent did not appeal from the holding of the Tax Court of no reorganization under sec. 368(a)(1)(F), the Court of Appeals held there was a reorganization under (F) and then alternatively under (D) and that petitioners received dividends up to the earnings of both Warehouse and Water Company. Respondent on page 11 of his memorandum concedes there was no (F) reorganization.

The holding that there was a dividend from Water Company is directly in conflict with the fundamental proposition that, if a corporation buys property from its stockholders, there is no dividend except where the corporation

pays more than the fair value of the property and then only to the extent of the excess. In *Palmer v. Commissioner*, 302 U.S. 63, this Court announced this obvious rule at page 69:

> "While a sale of corporate assets to stockholders is, in a literal sense, a distribution of its property, such a transaction does not necessarily fall within the statutory definition of a dividend. For a sale to stockholders may not result in any diminution of its net worth and in that case cannot result in any distribution of its profits.
>
> "On the other hand such a sale, *if for substantially less than the value of the property sold*, may be as effective a means of distributing profits among stockholders as the formal declaration of a dividend. The necessary consequences of the corporate action may be in substance the kind of a distribution to stockholders which it is the purpose of § 115 to tax as present income to stockholders, and such a transaction may appropriately be deemed in effect the declaration of a dividend, taxable to the extent that the value of the distributed property exceeds the stipulated price." (Emphasis added).

See among many other cases to the same effect: *Southern Ford Tractor*, 29 T.C. 833, 842; *Rodman Wanamaker Trust*, 11 T.C. 365, aff'd 178 F.2d 10; *Emma Cramer*, 20 T.C. 679 (acq. 1960-1 C.B. 4); and *Trianon Hotel Company*, 30 T.C. 156.

As stated above, Water Company paid $700,000 for the properties and it is conceded that their fair value was at least $700,000. So, there was no excess payment. The net value of the Water Company's assets was not reduced as the properties it received of a value of $700,000 replaced the $700,000 cash it paid. Yet, if this Court does

not grant our petition and hear this case, petitioners will be faced in the Tax Court with the order of the Court of Appeals that there was a sec. 368(a)(1)(F) reorganization and petitioners received dividends equal to the accumulated earnings of both Warehouse and Water Company.

Respondent argues (pages 3, 4 and 8) that, if Warehouse had distributed $215,000 to petitioners and Water Company had distributed $700,000 to them, these amounts would be dividends; petitioners could then have the Warehouse assets transferred to Water Company; and, therefore, respondent says that it should be held that this is what was done. This Court has emphatically rejected this line of argument in many cases. In *Turnbow v. C.I.R.*, 368 U.S. 337, 342, it said concerning these reorganization provisions:

> "* * * Petitioner then argues that inasmuch as his transaction *would have been* a 'reorganization,' as defined in §112(g)(1)(B) and used in §112(b)(3), and hence 'would [have been] within the provisions of subsection (b) . . . (3),' 'if it were not for the fact that the property [he] received' consisted 'not only of' voting stock 'but also of . . . money,' §112(c)(1) authorizes the *assumption*, as respects the Foremost stock he received, that the exchange *was* a 'reorganization,' as defined in §112(g)(1)(B) and used in §112(b)(3), and hence precludes recognition of his gain 'in excess of the . . . money' he received.
>
> 'But we cannot agree that §112(c)(1) authorizes the assumption, contrary to the actual facts, of a 'reorganization,' as defined in §112(g)(1)(B) and used in §112(b)(3). To indulge such an assumption would actually be to permit the negation of Congress' carefully composed definition and use of 'reorganization of gains on what are, in reality, only sales, the

> full gain from which is immediately recognized and taxed under the general rule of §112(a).'"

Incidentally respondent states (page 3) that

> "since $700,000 of Water's accumulated cash, as well as $215,000 of Warehouse's cash, was being distributed, petitioners were taxable as a dividend to the extent of both corporations' earnings and profits."

Water Company had no $700,000 accumulated cash, but on the contrary to get the $700,000 needed it had to borrow on the day of the purchase $500,000 from a bank. (Davant, R. 59, Clements R. 121-123).

We ask why respondent does not even refer to the history of sec. 304 of the Code and *Rodman Wanamaker Trust,* 11 T.C. 365 and the other cases discussed on pages 22-24 of our petition. Briefly the *Wanamaker* case held that, if a subsidiary purchased stock in its parent company, this was not a dividend to the selling stockholder. The Revenue Act of 1950 provided that this would be a dividend but the Senate rejected the further proposal by the House to make it a dividend for one commonly held corporation to buy the stock of the other corporation. By sec. 304 of the 1954 Code Congress did provide such a purchase of stock would be a dividend but refused to make it a dividend for one such corporation to buy the assets of the other corporation, as was done in this case. As noted on page 24 of our petition the Commissioner finally acquiesced in that line of cases. But now we find those presently representing the respondent attempting to get around that expressed will of Congress by twisting sec. 368(a)(1)(D) and (F) so as to make the purchase of such assets a dividend after all. We submit that they should not be allowed to succeed.

We respectfully disagree with respondent's statement on page 10 as follows:

> "Moreover, the result reached by the court of Appeals prevents the use of the reorganization sections to escape taxation by converting into capital gains distributions which are in effect dividends out of accumulated earnings and profits, and is in accord with the announced objectives of Congress in enacting the corporate reorganization and related dividend provisions of the 1954 Code—namely, 'to insure that transactions which are in substance, although not in form, dividend distributions * * * are subject to tax at ordinary income rather than at capital gain rates.' S. Rep. No. 1622, 83d Cong., 2d Sess., p. 42."

His quotation from the Senate report is entirely out of context and does not have the meaning attributed to it. The full statement by the Senate Finance Committee referred to (S. Rep. No. 1622, 83d Cong., 2d Sess., p. 42) is as follows:

> "The House bill, in the opinion of your committee, contains several important provisions which, by spelling out detailed rules in an attempt to achieve almost mathematical certainty, would *make it difficult for necessary business transactions to be carried out with a minimum degree of interference from the tax laws.*
>
> The House bill in this area is, in substance, an entirely new statute using few of the terms or concepts with which the courts or the bar have become familiar over the years. Your committee has sought a less extreme approach. Rather than to replace the existing statute, *it has sought to rewrite it so as to preserve the terms and concepts of existing law wherever possible.* It has, however, not hesitated to depart from the present statute *where such departure was necessary in order to remove unwarranted restrictions*

> *on necessary or desirable business transactions* or to preclude the use of avoidance devices which proved successful under the existing code. Thus, your committee would liberalize present law with respect to the nonrecognition of gain or loss in cases which involve mere rearrangements of the corporate structure while at the same time providing less liberal rules in other areas in order to insure that transactions which are in substance, although not in form, dividend distributions by corporations to their shareholders are subject to tax at ordinary income rather than at capital gain rates." (Emphasis added).

To all who have followed the Tax laws from 1921, when the Congress began to write definitions of reorganizations, it is clear that their purpose has been primarily to provide that, where a profit is purely a paper profit represented by certificates of stock, the taxpayer will not be taxed on his profit until he gets cash with which to pay his tax through a sale or other disposition of his stock. At the same time, they provided that, if his profit is in both stock and cash on notes, he has the funds to pay the tax on the latter and so, they taxed that profit immediately. They did this through their definitions of "reorganizations." It is perfectly clear that they never intended a sale, for cash as in this case, to be classed as a reorganization.

We ask how in a sec. 368(a)(1)(D) reorganization both corporations can distribute "boot" under sec. 356? Yet respondent states on page 9:

> "Of course, if both merging corporations distribute boot to their stockholders, each group of stockholders would be subjected to a dividend tax to the extent of the earnings and profits in which they owned stock."

Section 356(a)(1) provides:

> "If—
>
> (A) section 354 or 355 would apply to an exchange but for the fact that
>
> (B) the property received in the exchange consists not only of property permitted by section 354 or 355 to be received without the recognition of gain but also of other property or money,
>
> then the gain, if any, to the recipient shall be recognized, but in an amount not in excess of the sum of money and the fair market value of such other property."

When one corporation transfers its properties to another for stock and money, the money is the "boot" and the transferor corporation is the only one distributing "boot".

Respondent states on page 10:

> "Petitioners' principal contention (Pet. 6, 13) is that the court below erred in holding that the instant transaction constituted an 'F' reorganization, i.e. 'a mere change in identity, form, or place of organization, however effected.' "

We cannot conceive how respondent says that that is our principal contention in view of our petition, pleadings, proof and briefs. We emphatically urge every contention we have made, and, without limiting that statement, we particularly urge our position that there is not here any sec. 368(a)(1)(D) reorganization. As we point out on pages 18 to 20 of our petition, this whole line of cases, holding that the specific requirements of sec. 368(a)(1)(D) need not be met if the stock of both corporations is

owned by the same parties, started with the two-to-one decision by the Third Circuit Court of Appeals in *Commissioner v. Morgan,* 288 F.2d 676, under the 1939 Code, with Judge Hastie strongly dissenting. Later cases have merely followed it blindly. The taxpayers and the members of the bar do not agree with that line of argument. This is shown by cases questioning it in presently pending petitions for certiorari in this Court, *Moffatt v. Commissioner,* 363 F.2d 262, petition No. 804, this Term; *Reef Corporation v. Commissioner,* 368 F.2d 125, petition No. 1005, this Term; *Babcock v. Phillips,* petition No. 1215, this Term.

CONCLUSION

We respectfully pray that our petition for certiorari be granted. If it is refused, the case will go back to the Tax Court under the main holding by the Court of Appeals that there was a sec. 368(a)(1)(F) reorganization, which was contrary to the holding of the Tax Court, from which holding respondent did not appeal and which holding respondent admits in this Court was erroneous, and a direction to the Tax Court to hold petitioners received dividends equal to the combined earnings of the Warehouse Company and the Water Company. If there were no reorganization under (F), there is no possible basis to sustain taxation of petitioners on dividends to the extent of the earnings of both Warehouse and Water Company under sec. 368(a)(1)(D), or sec. 356 or any other section of the Internal Revenue Code. The Tax Court itself has consistently held that, where there is a reorganization of two commonly owned corporations, as here, under sec. 368(a)(1)(D), the earnings of only the transferor corporation are to be considered in determining the

amount of dividends received and the earnings of the transferee corporation are not taken into account. Ralph C. Wilson, Sr., 46 T.C. No. 32 (1966); James Armour, Inc., 43 T.C. 295; and the decision of the Tax Court in the present case.

If the judgments of the lower courts are allowed to stand, then the Senate Finance Committee certainly failed in its stated attempt to preserve the concepts with which the courts *and the bar* had become familiar over the years.

Respectfully submitted,

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